Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:NR:DAL:PREF-126193-02
TALudeke

date: July 17, 2001

to: Carol Paulson
Revenue Agent

from: Associate Area Counsel
Natural Resources

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subject: [redacted]
Decision Date Analysis

This memo responds to your request for assistance of July 2, 2002. It should not be cited as precedent.

You asked for assistance in determining the proper decision date for the merger between [redacted] and [redacted]. You also requested our assistance in determining a method for allocating the fees incurred by [redacted] and [redacted]. For the reasons set forth below, we believe that the correct decision dates are [redacted] for [redacted] and [redacted] for [redacted] Using these decision dates, we've provided a breakdown that allocates the various fees incurred.

STATEMENT OF FACTS

[redacted] and [redacted] first entered into a confidentiality agreement on [redacted] That agreement included a three-year standstill provision. In early [redacted], [redacted] and [redacted] terminated their negotiations primarily due to differences over integration and management succession issues. No due diligence was performed at this time.

In early [redacted], after [redacted] acquired [redacted], [redacted]'s and [redacted]'s CEOs began to discuss a merger of the two companies. These discussions soon stalled. At the same time, [redacted] identified [redacted] and [redacted] as potential acquisition candidates. Though [redacted] preferred [redacted] over these companies, it investigated them as potential alternatives. Based on the initial due diligence conducted by [redacted], it chose not to pursue these firms.

On [redacted], [redacted] hired [redacted], [redacted] to assist it in connection with a possible transaction with [redacted] or another firm. [redacted] also examined other financial alternatives for [redacted]. On [redacted], [redacted] held a regularly scheduled board meeting. At that meeting, [redacted] presented several financial alternatives to [redacted] On [redacted] the [redacted] board held another regularly scheduled meeting. At that meeting, [redacted] outlined three strategic alternatives available to the company. One of the alternatives was to pursue a merger; [redacted] identified three potential merger candidates, including [redacted]

By late [redacted] began to see [redacted] as vulnerable to a takeover because of [redacted] s current market valuation. In [redacted], the CEO of [redacted], spoke briefly with [redacted] s CEO about a merger. The two agreed to meet later to discuss a potential combination.

On [redacted], the [redacted] board held a regularly scheduled meeting. At that meeting, the board authorized [redacted]'s CEO to continue discussions with [redacted] On [redacted], he met with [redacted] and other representatives of [redacted] to discuss the possibility of a merger.

In early [redacted] and [redacted], financial advisers to [redacted], became involved in the potential [redacted] transaction. The firms provided general financial advice, perform detailed due diligence, and ultimately took an active role in negotiating the transaction. On [redacted], [redacted]'s and [redacted]'s financial advisers met to discuss the possible terms of a merger. At that meeting, the advisers agreed that certain due diligence must be completed before either company could further consider the transaction. At this time, neither company had performed any detailed due diligence.

On [redacted], at a regularly scheduled meeting, [redacted] s board authorized management to continue discussions with [redacted]. The next day [redacted] and [redacted] signed a confidentiality agreement which included a two-year standstill provision. On [redacted], the [redacted] board held a special meeting. At the meeting, the board expressed concern over the potential merger with [redacted]. On [redacted], [redacted]'s CEO called [redacted] to advise him that [redacted] would not meet projected earnings targets for the third and fourth quarters of [redacted]. The earnings shortfall made [redacted] uncomfortable with [redacted]'s valuation and future earnings projections. With this in mind, [redacted] decided to perform an in-depth due diligence of [redacted] s business.

On [redacted], executives of [redacted] and [redacted], accompanied by their financial advisers, met to discuss [redacted] s preliminary due diligence findings and [redacted] s current and projected financial performance. [redacted] indicated to [redacted]'s CEO that he expected to submit a verbal offer to acquire [redacted] after obtaining approval from the [redacted] board. The approval was only to submit a preliminary verbal offer subject to due diligence issues being resolved.

On [redacted], the [redacted] board held a special meeting. At that time, the board was told that [redacted] would submit a proposal to [redacted] early the following week. The same day, the [redacted] board held a regularly scheduled meeting. At that meeting, the board authorized management to submit the preliminary offer to [redacted]. At this point in time, [redacted] was in the preliminary stages of understanding the Department of Justice's potential divestiture requirements and had not completed its due diligence review of [redacted]. Furthermore, [redacted] had not received any financing proposals that it could evaluate to see the transaction with [redacted] could be done on terms consistent with its strategic plans. Both of these issues needed to be resolved before the board could make a final decision to enter into a proposed transaction with [redacted] On [redacted], [redacted], through its financial advisers, verbally delivered its preliminary price offer to [redacted], subject to due diligence. On [redacted], [redacted]'s management and advisers briefed the board on the terms and conditions of [redacted]'s verbal offer. The offer provided that [redacted] stockholders would receive $[redacted] in cash and [redacted] shares of [redacted] common stock for each share of [redacted] stock.

On [redacted], the [redacted] board held a regularly scheduled meeting. [redacted] and [redacted]'s management described the terms and conditions of [redacted]'s offer. [redacted]'s outside legal advisers reviewed the fiduciary duties of the [redacted] board in connection with the possible sale of the company. The board also discussed the potential synergies from a combination with [redacted], the proposed timetable of the merger, expected market reaction, and strategic alternatives to the offer. [redacted] indicated that there were other strategic buyers more focused on [redacted] products. The board authorized management, [redacted] and outside counsel to enter into discussions with [redacted] to further explore the offer.

At this time, the main concern of the [redacted] board was the extent of the Department of Justice's required divestitures of certain [redacted] plants and operations. If DOJ were to require more divestitures than the [redacted] board was comfortable with, [redacted] would have decided to discontinue discussions of the proposed transaction with [redacted]. [redacted] also had concerns about the [redacted]'s interest in [redacted].[1] As such, [redacted] believed that further due diligence was required to gain a better understanding of the potential business combination involving [redacted] and [redacted].

In early [redacted] and [redacted] conducted further due diligence of [redacted]'s business operations. During that period, [redacted] also continued its discussion with various commercial lenders about financing the merger. On [redacted], [redacted] delivered an initial draft of a merger agreement to [redacted].

On [redacted], the [redacted] board held a special meeting. At the meeting, the potential merger with [redacted] was discussed. Following this discussion, the board decided on a price offer and authorized management to deliver the offer and to continue discussions with [redacted]. According to [redacted]'s Vice President of Corporate Development, although an offering price was decided upon, the board was still unsure of the extent of divestitures that DOJ might require as a condition to approving the merger. Thus, the board was not in a position to determine whether or not to proceed with a transaction with [redacted]. On [redacted], [redacted] verbally delivered the second offer to [redacted].

On [redacted], the [redacted] board held a regularly scheduled meeting. At that time the [redacted] board did not make a final decision regarding the merger with [redacted]. On [redacted], [redacted]'s CEO and [redacted], along with their financial advisers, met to negotiate the merger agreement. At that meeting, they decided that they would meet in [redacted] on [redacted] to

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[1] [redacted].

finalize the merger agreement. On [redacted], during that meeting, [redacted] and [redacted] reached an impasse and the companies suspended their merger discussions. The next day, at a special meeting of the [redacted] board, the board authorized [redacted]s management to continue discussions with [redacted]. On [redacted], [redacted] CEO called [redacted] to further discuss the issues raised in the meeting on [redacted]. During that conversation, they reached agreement on several material provisions of merger agreement. The same day, [redacted] board held a special meeting to discuss the state of the merger negotiations. The board authorized management to continue its negotiations with [redacted] and agreed to meet again on [redacted] to consider approving the final transaction.

On [redacted], during the meeting held to discuss the merger, negotiations broke down again, and the companies suspended their merger discussions. [redacted] requested that certain key employees be given bonuses and other employees awarded severance packages. [redacted] also believed its operations justified a higher price than in the current offer. With these requests in mind, [redacted] believed that the transaction was not feasible and decided to terminate discussions with [redacted]. The next day, the [redacted] board held a special meeting. Though no issues were resolved at that meeting, the board authorized [redacted]'s management to resume discussions with [redacted]. On [redacted], [redacted]'s CEO called [redacted] to further discuss the issues raised on [redacted]. During that conversation, they reached agreement on several issues. The same day, [redacted]'s board held a meeting to discuss the status of the merger negotiations. The board authorized management to continue negotiations with [redacted].

From [redacted] to April 3, 2001, [redacted]'s and [redacted]'s executives and advisers continued negotiating the merger agreement. On [redacted]'s board and [redacted]'s board approved the merger. On [redacted], the merger between [redacted] and [redacted] closed. [redacted] shareholders ultimately received $[redacted] in cash and [redacted] shares of [redacted] common stock for each share of [redacted] stock - the same terms included in the [redacted] preliminary offer that was made on [redacted].

ANALYSIS

[redacted] provided a lengthy memo that it claims support using [redacted] as the decision date for the merger. According to [redacted], prior to [redacted], the companies had not decided *whether* to enter a new business or *which* new business to enter.[2] Guidance for determining the appropriate decision date is provided in Rev. Rul. 99-23, 1999-1 C.B. 998 and one of a half and and *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

Rev. Rul. 99-23 addressed three different factual situations. In the first situation, in April 1998 a corporation, U, hired an investment banker to evaluate the possibility of acquiring a new

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[2] Though [redacted] discusses the whether and which test, it doesn't claim that [redacted] and [redacted] ever investigated merger partners outside their industry. Thus, the only real issue is the date the firms focused on a combination of their assets.

business. After a lengthy investigation, U focused on companies in a specific industry. The investment banker evaluated several businesses in that industry, including V. The investment banker commissioned appraisals of V's assets and commenced an in-depth review of V's books and records in order to determine a fair acquisition price. On November 1, 1998, the U entered into an agreement with V to purchase all of its assets.

In the second situation, corporation W began searching for a trade or business to acquire in May, 1998. Anticipating finding a suitable target, W hired an investment banker to evaluate three potential alternatives. At the same time, W hired a law firm to begin drafting regulatory approval documents. Eventually, W decided to purchase X.

In the third situation, Y hired a law firm and accounting firm to assist in the potential acquisition of Z by performing services the parties labeled "preliminary due diligence." These services included conducting research on Z's industry and analyzing financial projections for Z for 1998 and 1999. In September 1998, at Y's request, the law firm prepared and submitted a letter of intent to Z. The offer contained in the letter resulted from prior discussions between Y and Z, specifically stated that a binding commitment with respect to the proposed transaction would result only upon execution of an acquisition agreement. Thereafter, the law firm and accounting firm continued to provide services labeled as "due diligence," including a review of certain documents of Z. On October 10, 1998, Y entered into an acquisition agreement with Z to purchase all of its assets.

Before analyzing the three situations, the FSA set forth a general rule for determining when expenditures incurred in the purchase of the business should be capitalized. This determination centers upon whether expenditures were incurred before or after the decision was made whether to enter a new business and which new business to enter:

> [E]xpenditures incurred in the course of a general search for, or an investigation of, an active trade or business, *i.e.*, expenditures paid or incurred in order to determine *whether* to enter a new business and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation), are investigatory costs that are start-up expenditures under § 195. Alternatively, costs incurred in the intent to acquire a specific business are capital in nature and thus, are not startup expenditures under § 195. The nature of the costs must be analyzed based on all the facts and circumstances of the transaction to determine whether it is investigatory costs incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties used to describe the cost and the point in time at which the costs is incurred do not necessarily determine nature of the cost.

Id. at 5.

In Situation 1, the Service determined that Y made its decision to acquire V after the investment banker conducted research on several industries and evaluated publicly available financial information. It noted, "[t]he costs incurred to conduct industry research and review public financial information are typical of the costs related to a general investigation, " *Id.*, and were eligible for amortization as startup expenditures under § 195. But the costs related to the appraisal of V's assets and review of V's books and records were capital acquisition costs. Importantly, the Service noted that if the evaluation of V's competitors occurred after the decision to acquire V was made, those costs were capital.

In Situation 2, the Service determined that the costs incurred to evaluate potential businesses were investigatory. The cost of drafting regulatory approval documents, however, even if incurred prior to the time W decided to purchase X, were not start-up expenditures, but were facilitative of the purchase and were capital.

The third situation is the most factually nuanced of the three. There, the Service determined that Y made its decision to acquire Z in September 1998, around the time that it instructed its law firm to prepare and submit a letter of intent. The due diligence costs incurred prior to that time "are typical of the costs incurred during investigation to determine whether to acquire a new business and which new business to acquire," *Id.*, and are investigatory. Due diligence costs incurred after that time, however, related to the attempt to acquire Z and must be capitalized.

Wells Fargo addressed a more complicated factual situation concerning the merger of Davenport Bank and Norwest. Davenport was a small bank located in Iowa. In 1989, when the state of Iowa adopted interstate banking legislation that allowed the acquisition of Iowa-based banks by out-of-state banks, Davenport feared that banks of its size would no longer be competitive. As a result, Davenport began to consider the idea of merging with another bank.

During 1990, Norwest and Davenport began the talk about merging. On June 10, 1991, Davenport's Board of Directors met to consider merging into Norwest. The board authorized the firm's executive directors to negotiate with Norwest and to hire legal and other representatives with the intent to recommend to the board a letter of intent between Davenport and Norwest. The board also appointed a committee to perform an independent due diligence review. On the same day, Norwest's Board of Directors authorized using up to 10 million shares of Norwest common stock to purchase Davenport.

On July 22, 1991, Davenport's board met to consider the merger. At that meeting, the special committee recommended that the transaction be approved and Davenport's banker opined that the transaction was fair to Davenport's shareholders. The board approved the transaction.

On the same day, Norwest entered into an agreement whereby they agreed to the transaction subject to regulatory approval, approval of Davenport shareholders, and the satisfaction of certain conditions including regulatory approval and accounting and tax considerations. Norwest also entered into an agreement with certain shareholders of Davenport that agreed to vote in favor of the transaction and issued a press release announcing the merger. After signing the agreement, Norwest commenced a due diligence review of Davenport which continued throughout August.

In order to determine which expenses should be capitalized the court applied revenue ruling 99-23, noting, "this Court agrees with the IRS than any investigatory expenses which post-date the 'final decision' to acquire a business ought to be capitalized." *Id.* at 889. Thus the court had to determine the final decision date. With little analysis, the court concluded that the final decision date was July 22, 1991, the date Davenport and Norwest entered into the Agreement and Plan of Reorganization. The court did note that "[o]ur determination on this point is not to be construed as a 'bright line rule' for determining when a ' final decision' has been made. The facts and circumstances of each case must be evaluated independently to make a proper finding on that issue. " *Id.*

I. The Decision Date

Here, there are two decision dates that are relevant: [redacted]'s and [redacted]'s.

A. [redacted]

In early [redacted] first began to consider purchasing [redacted]. At this date, [redacted] was also considering purchasing at least two other companies. After performing an initial due diligence on these companies, however, it chose not to consider purchasing them. Even as early as [redacted] then, [redacted] was already more-or-less focused on [redacted]. In late [redacted] began to see [redacted] as a potential takeover target because of its current market valuation. In [redacted] spoke briefly with [redacted]'s CEO about a merger.

In early [redacted], [redacted] and [redacted] became involved in the potential [redacted] transaction. On [redacted]'s board authorized management to continue discussions with [redacted]. On [redacted], [redacted] told [redacted] CEO that he expected to submit a verbal offer after obtaining approval from the [redacted] board. The next day, the [redacted] board held a regularly scheduled meeting. At that meeting, the board authorized management to submit a preliminary offer to [redacted].

By February 22, therefore, [redacted] was prepared to purchase [redacted]. Though the transaction was not consummated until six weeks later, under the relevant authority, [redacted] is the correct decision date.

The various situations in the revenue ruling all support the conclusion that [redacted] is the decision date. Though the facts are somewhat abbreviated, in situation 1, the Service held that the cost of appraising the targets' assets and an in-depth review of the targets' books and records were capital acquisition costs. In situation 2, the Service held that the process of drafting documents related to the merger- even those occurring before the final decision date - were capital. In the third situation, the Service determined the decision was made at the time the acquirer instructed its law firm to prepare and submitted a letter of intent. Each of these situations can be applied to the [redacted] decision.

As in situation 1, [redacted] focused its due diligence efforts on [redacted] after an initial industry analysis. After this analysis, [redacted] decided not to pursue a merger with [redacted] or [redacted]. In fact, [redacted] noted that its preliminary offer was contingent on further due diligence being performed. As in situation 2, [redacted] began drafting the merger agreement long before the final board approval. According to [redacted], sometime in early [redacted] and [redacted] were hired, in large part - if not solely - to work on the [redacted] acquisition. And, as in situation 3, long before the board approval [redacted] authorized management to make a preliminary offer to [redacted] with the same terms as those ultimately agreed to.

[redacted] will undoubtedly point to the fact that in *Wells Fargo* the court determined that the decision date was the date the Board of Directors approved the purchase. As that court specifically said "[o]ur determination ... is not to be construed as a ' bright line rule' for determining when a ' final decision' has been made." *Wells Fargo*, 224 F.3d at 889. It should also be noted that much of the due diligence in *Wells Fargo* was performed after the final board approval - not before as was the case with [redacted]. Moreover, as was the case with the allegedly preliminary offer here, even after board approval, the merger in *Wells Fargo* was contingent on certain regulatory and accounting issues. In short, on [redacted], [redacted] had definitely decided to acquire [redacted]. Though [redacted] may have rejected the offer, had it accepted it, the merger would have been complete. Though [redacted] characterized that offer as preliminary, this characterization is not determinate. *See* Rev. Rul. 99-23 (noting that the labels the parties use do not necessarily determine the nature of the cost). That this characterization should not be respected is evident in the fact that the final merger terms (at least financially) were the same as in this allegedly preliminary offer.

B. [redacted]

Unlike [redacted] did not care to make a final decision regarding the merger until the board meeting on [redacted]. On [redacted], for example, rather than excepting the preliminary offer, [redacted]'s board authorized management to further explore the offer received from [redacted]. On March 23, 2001, the board still had concerns with the [redacted] matter. A few days later, during discussions with [redacted] raised additional concerns, including bonuses, severance packages for departing employees, and the price [redacted] had offered. It was not until [redacted] and [redacted] that the [redacted] board was comfortable with the merger agreement. It seems reasonable, therefore, to treat [redacted] as the final decision date for [redacted]

II. The Fees

Having decided upon the decision dates for [redacted] and [redacted] it is now necessary to allocate the various fees incurred prior to entering the merger. These fees can be separated into two categories: legal and accounting fees and investment banking fees.

A. Legal and Accounting Fees

Legal and accounting fees are similar in that they both are based upon invoices that reference the dates the services were performed. Thus it is easy to determined whether expenses in these categories were performed before or after the decision date. [redacted] has already allocated expenses in these categories that were performed prior to the decision date into ordinary (or amortizable) and capital. Though we might disagree with certain of these allocations, it's unlikely that any disagreement would lead to a material difference. Thus, the best method for allocating these fees is to accept [redacted]'s allocation of the pre-decision date fees. The only change necessary, therefore, is to ensure that all fees incurred between [redacted] and [redacted] by [redacted]'s advisers are capitalized. The fees incurred by [redacted] and [redacted] fees prior to [redacted] can be accepted as provided in [redacted]'s submission.

B. Investment Banking Fees

Unlike the legal and accounting fees, the investment banking fees were not broken down by date. Rather, the fees were based upon a successful completion of the merger. Thus there's no way to break down the fees by examining detailed invoices. But the fees can be allocated by date.

Allocating the fees by date requires analyzing [redacted]'s and [redacted]'s fees separately. Not only did the decision dates differ for the two firms, but their respective investment bankers also started working on different dates. The only consistent date between the two firms is [redacted] - the date the merger closed.

1. [redacted]

[redacted]'s investment bankers began work in early [redacted]. [redacted] finally decided upon the merger on [redacted]. Using [redacted] as the starting date for the investment bankers, the [redacted] fees can be allocated as follows:

		Days Expired
Beginning Date	[redacted]	[redacted]
Decision Date	[redacted]	[redacted]
Closing Date	[redacted]	[redacted]

The percentage of time spent working pre-decision date is [redacted]/[redacted] or [redacted] percent. That amount of the investment banking fees can be amortized. The remainder of the cost should be capitalized as facilitative of the merger.

2. [redacted]

[redacted] hired [redacted] on [redacted]. [redacted] finally decided upon the merger on [redacted]. The [redacted] fees can be allocated as follows:

Days Expired

Beginning Date [redacted]
Decision Date [redacted]
Closing Date [redacted]

The percentage of time spent working pre-decision date is [redacted] or [redacted] percent. That amount of the investment banking fees can be deducted. The remainder of the costs should be capitalized as facilitative of the merger.

Undoubtedly [redacted] will contend that these allocations are incorrect. It should be noted, however, that a good argument could be made that all of [redacted]s investment banking costs relate directly to the merger. After all, the two investment banking firms were hired to work on the merger.[3] [redacted] has a better argument that the [redacted] allocation should be more favorable to [redacted]. Unlike the [redacted] investment bankers, [redacted] performed many functions that did not relate to the merger.[4]

CONCLUSION

The decision date that [redacted] chose for [redacted] is correct. The decision date for [redacted] is not. As a result, the allocation and for the [redacted] legal and accounting fees must be changed slightly. These allocations for the investment banking fees for those firms are unpersuasive. [redacted] provides nothing more than self-serving affidavits to support its case. A cursory look at the dates that the investment bankers were hired demonstrates that the affidavits and are not persuasive. Rather than the [redacted]/[redacted] allocation that [redacted] uses, a more realistic allocation allocates

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[3] The arrangement that [redacted] hired its investment bankers under specifically related to the potential acquisition of [redacted] - the code name for [redacted].

[4] The arrangement had [redacted] hired [redacted] required [redacted] to provide general financial advice as well as assistance with a potential merger with [redacted] or another firm.

almost all of [redacted]'s investment banking fees to the merger. [redacted]'s investment banking fees should also be allocated to the merger at a higher percentage than [redacted] proposes.

This advice is subject to post review by the National Office. This procedure takes ten days and I will notify you if the National Office does not agree with this advice. If you have any questions regarding this memo, please contact Todd Ludeke at (972) 308-7926.

John S. Repsis
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By:____________
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